Joint Committee on Taxation
September 10, 1986
JCX-24-86

TAX ASPECTS OF H.J. RES. 626
(COMPACT OF FREE ASSOCIATION WITH THE GOVERNMENT OF PALAU)

Introduction

The following is background information and staff analysis concerning the tax provisions of the proposed Compact of Free Association with the Government of Palau (H.J. Res. 626). These tax provisions are equivalent in all relevant respects to those that Congress adopted for the Federated States of Micronesia and the Marshall Islands in 1985 (H.J. Res. 187, as amended, Public Law 99-239). Congress adopted those tax rules for Micronesia and the Marshalls only after significantly limiting the tax benefits originally proposed to Congress for those areas.

H.J. Res. 626 was originally referred jointly to the Committees on Foreign Affairs and Interior and Insular Affairs. The Committee on Foreign Relations approved the Compact with an amendment on June 26, 1986 (H. Rept. 99-663, Part I), and the Committee on Interior and Insular Affairs approved it with an amendment on July 23, 1986 (H. Rept. 99-663, Part II). The Committee on Ways and Means has been instructed by the Speaker to consider H.J. Res. 626 by September 17, 1986, with respect to the tax and trade aspects of the proposed Compact. In addition, the Compact has been referred for a period ending not later than September 17, 1986, to the Committees on Armed Services, the Judiciary, and Merchant Marine and Fisheries for consideration of such provisions as fall within the jurisdictions of those committees, and to the Committee on Appropriations for a period not to exceed 15 legislative days. (The Appropriations Committee was discharged on August 15, 1986.)

Part I provides background information on the proposed Compact; Part II discusses the relevant tax provisions under present law and H. J. Res. 626.

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I. Compact Of Free Association

The Trust Territory of the Pacific Islands was created in 1947 by an international "trusteeship agreement" under the aegis of the United Nations. Palau is one of several jurisdictions within the Trust Territory. The United States has administered the Trust Territory since 1947 pursuant to the authority granted by the agreement. Thus, the legal basis of U.S. authority in the Trust Territory has been quite different from the basis of its authority in its possessions, such as Puerto Rico, the Virgin Islands, or Guam. The United States exercises sovereignty over those possessions, but it has governed the Trust Territory under an international legal agreement, without any claim to sovereignty, and with the ultimate goal of making the Trust Territories self-determining states in their own right. To that end, U.S. control over one jurisdiction of the Trust Territory--Palau--would be largely eliminated under the proposed Compact of Free Association. In 1985, Congress voted to allow somewhat similar treatment to two other areas of the Trust Territory: the Marshall Islands and the Federated States of Micronesia (P.L. 99-239).

The Compact would establish a relationship which is neither commonwealth status, under which the associated states would submit to U.S. sovereignty, nor fully independent status. Under the terms of the proposed Compact, Palau would be a self-determining sovereign state with full control over its internal and external affairs. However, the U.S. would retain certain security rights in Palau, including a right to deny the territory of Palau to the military forces of any third nation. Under the Compact, the United States will spend an estimated $443 million for Palau over the next 15 years, a projected increase of some $8.5 million over the U.S. spending projected absent the Compact.

II. Tax Provisions

Present Law

Because the Trust Territory of the Pacific Islands has never been a true territory or possession of the United States, Palau has never been treated as a possession for U.S. tax purposes. Rather, Palau has been treated as a foreign country, subject to the normal U.S. international tax rules. In general, those rules provide that U.S. taxpayers are fully subject to U.S. tax on income earned anywhere in the world. However, any foreign taxes paid on income earned abroad may be credited against the U.S. tax payable on such income. Thus, when taxes have been imposed on U.S. taxpayers by

Palau, those taxes have been creditable against U.S. tax liability. An alternative benefit may be available to individual taxpayers under section 911 or 912 of the Internal Revenue Code; section 911 allows private sector workers to exclude from gross income for U.S. tax purposes up to $80,000 of income earned abroad annually (an amount that would be reduced to $70,000 under the conference agreement on the Tax Reform Act of 1986, H.R. 3838) plus a housing cost allowance, while section 912 grants an exclusion for certain cost-of-living and other allowances paid to U.S. government employees outside of the 48 contiguous states.

With respect to foreign persons earning income from sources within the United States, the United States applies different taxing rules to different types of income. Income from U.S. sources that is effectively connected with a U.S. trade or business is taxed under normal U.S. income tax rules (i.e., on a net basis at graduated rates). On the other hand, U.S.-source income that is not connected with the taxpayer's trade or business (typically dividends, rents, royalties, and some interest) is taxed at the flat rate of 30 percent of the gross amount of income. The 30-percent rate is often modified by treaty. (Because this tax is collected by requiring the U.S. payor to withhold the tax from amounts paid, it is often called a withholding tax.)

Palau has been fully subject to the rules applicable to foreign countries. Section 936, which provides a credit that offsets all U.S. tax on qualified income of U.S. corporations operating primarily in the possessions, does not apply to Palau. The conference agreement with respect to the Tax Reform Act of 1986, H.R. 3838, would modify the possessions tax credit (section 936).

H.J. Res. 626

The terms of the proposed Compact relating to taxation are set forth in sections 252 through 255. A provision requiring Presidential reports on the impact of the Compact appears in section 103.

Authority to tax U.S. persons

Section 252 of the compact provides that Palau may tax U.S. persons on income earned in, property located in, or products consumed in Palau. This authority extends to taxation of transfers of property by gift or at death. The source of income and the location of property are to be determined under the U.S. Internal Revenue Code. This provision of the Palau Compact treats Palau in the same way that Congress treated Micronesia and the Marshall Islands in Public Law 99-239.

Exemption from U.S. transfer taxes

Section 253 exempts citizens of the Palau who are domiciled there and who are not U.S. citizens or U.S. residents from U.S. estate, gift, and generation-skipping transfer taxes. For this purpose, Palau law is to determine residence in or citizenship of Palau, while U.S. law is to determine residence in or citizenship of the United States. Under current law, while foreigners are nominally subject to these U.S. gratuitous transfer taxes, foreigners who hold U.S. assets through foreign corporations are not subject to those taxes. As a practical matter, the United States collects very little revenue from imposition of these taxes on foreigners. This provision of the Palau Compact treats Palau in the same way that Congress treated Micronesia and the Marshall Islands in Public Law 99-239.

Taxation of income derived in Palau

Section 254 of the Compact provides that the Government of Palau is to have the authority to impose tax on income derived by a resident from Palau from sources without Palau in the same manner and to the same extent as the Government of Palau imposes tax on income derived within its jurisdiction. If the Government of Palau exercises that authority to tax local residents on non-Palau income,[1] any individual resident of Palau who is subject to U.S. tax may be eligible for one of two kinds of U.S. tax relief with respect to the tax which would otherwise be imposed by the U.S. Government on that income. (For this purpose, a resident of Palau is any person who is physically present in Palau for a period of 183 or more days during any taxable year.) The relief available to U.S. persons means only (1) relief in the form of the foreign tax credit (or the deduction in lieu of the foreign tax credit) available with respect to the income taxes of a U.S. possession, and (2) relief in the form of the earned income exclusion of Code section 911. These kinds of relief are to be available under the compact only to the extent otherwise available under the Code. This provision of the Palau Compact treats Palau in the same way that Congress treated Micronesia and the Marshall Islands in Public Law 99-239.

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[1] If the Government of Palau subjects income to taxation substantially similar to the taxation imposed by the Trust Territory Code in effect on January 1, 1980, the Government of Palau shall be deemed to have exercised its authority to tax residents of Palau on foreign source income as it taxes Palau source income.

Possession tax credit

Section 255 of the Compact provides that Palau will be treated as a possession of the United States for the purposes of the possession tax credit (sec. 936). This 936 treatment will not apply to any period after 1986 during which there is not in effect between Palau and the United States an exchange of information agreement of the kind required for convention treatment for Caribbean Basin countries that provides information about the ownership of bearer shares and bank accounts.

If the extension of 936 benefits to Palau is, at any time during which the Compact is in effect, reduced, the Secretary of the Treasury is to negotiate an agreement with the Government of Palau under which, when that agreement is approved by U.S. law, Palau will be provided with benefits substantially equivalent to the section 936 benefits lost by virtue of that reduction. If within the one-year period after the date of the enactment of the Act making a reduction of benefits, such a negotiated agreement is not approved by law, the matter is to be submitted to an arbitration board established under section 424 of the Compact. For the purpose of this tax arbitration, the Secretary of the Treasury or his delegate is to be the member of the board representing the U.S. Government. Any decision of that Board in this type of matter, when approved by law, is to be binding on the United States only as to whether the United States has provided the substantially equivalent benefits referred to above. This provision of the Palau Compact treats Palau in the same way that Congress treated Micronesia and the Marshall Islands in Public Law 99-239.

Treatment of convention expenses

For the purpose of the provision of the Internal Revenue Code allowing deductions for certain expenses incurred at conventions, seminars, or similar meetings, Palau is to be treated as part of the North American area. Under that North American area treatment, U.S. tax deductions are allowable for conventions, seminars, or similar meetings held in Palau whether or not Palau is as reasonable a location for the meeting as the United States (sec. 255(d) of the proposed Compact). This provision of the Palau Compact treats Palau in the same way that Congress treated Micronesia and the Marshall Islands in Public Law 99-239.

Reports

Pursuant to section 103(e) of the proposed Compact, one year after the date of enactment of the Joint Resolution approving the Compact of Free Association between the United States and Palau, and annually thereafter, the President is to report to Congress with respect to the impact of the

Compact on the possessions of the United States and on the State of Hawaii. Any such report is to identify any adverse consequences resulting from the Compact and is to make recommendations for corrective action to eliminate any such consequence. Among the matters to which the reports are to pay particular attention is taxation. This provision of the Palau Compact corresponds roughly to the provision of Public Law 99-239, governing the U.S. relationship with Micronesia and the Marshall Islands, which requires a study of the tax effects of that Compact to be submitted to the Committee on Ways and Means of the House and the Committee on Finance of the Senate before October 1, 1987.

Effective date

These tax provisions apply to income earned, and transactions occurring, after September 30, 1985.